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Viewing cable 08MOSCOW2615, AFTER THE WAR WITH GEORGIA: RUSSIA'S ECONOMIC

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Reference ID	Created	Released	Classification	Origin
08MOSCOW2615	2008-09-02 11:49	2011-08-30 01:44	CONFIDENTIAL	Embassy Moscow

Appears in these articles:

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PP RUEHWEB

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E.O. 12958: DECL: 08/28/2018
TAGS: [ECON](#) [PREL](#) [PGOV](#) [ETRD](#) [EINV](#) [RS](#)
SUBJECT: AFTER THE WAR WITH GEORGIA: RUSSIA'S ECONOMIC
FUTURE MORE UNCERTAIN

REF: MOSCOW 2563

Classified By: Ambassador John R. Beyrle for Reasons 1.5 (b) and (d).

Summary

¶1. (C) That Russia is "back," at least economically, has been an insistent theme of the Kremlin the last few years. Russia's economic recovery from the depths of its financial crash in 1998 is indeed impressive. High growth, burgeoning international reserves, and rising living standards were the result of luck in the form of a five-fold increase in the prices of oil and gas, Russia's main exports, but also the result of prudent macroeconomic policies that stressed fiscal and monetary stability.

¶2. (C) We would argue, however that the Russian government has overstated the extent of this economic restoration and its sustainability. After seven years of 7 percent growth or better, per capita income remains below \$10,000 a year and only last year did Russia's GDP finally surpass its level in ¶1991. Moreover, unlike other emerging markets such as China and India, Russia's impressive growth has not been fueled by its manufacturing sector but rather by rising but volatile commodity prices.

¶3. (C) The underlying fragility of the Russian economy and its uncertain future have been brought into sharp focus by the war in Georgia. Some of our contacts agree with the line from the Russian government, that the economy will quickly recover from its current turmoil. Other observers believe that higher political risk has returned for the foreseeable future -- bringing with it lower economic growth. However, all of our contacts are increasingly pessimistic about the ability of the GOR to pursue the reforms needed to modernize and diversify the Russian economy.

Short Term Costs

¶4. (C) One of the persistent myths that Russian government officials press publicly about the Russian economy is that it is "decoupled" from the global financial system, by which these officials mean its growth and stability are not affected by global developments and specifically are immune to the effects of the sub-prime crisis in the United States. A corollary of this argument is that Russia is a "safehaven" for international investors. However, the performance of Russia's stock markets over the past two months and especially since the war with Georgia erupted belies these claims.

¶5. (C) As we have reported elsewhere, the Russian stock market began its slide in mid-May. Global conditions -- a strengthening dollar and softening demand for commodities -- were contributing factors. However, a series of government actions culminating in the decision to invade Georgia and recognize Abkhazia and South Ossetia's independence are principal causes that have driven the stock markets to their lowest levels in nearly two years, in the process wiping out hundreds of billions of dollars in shareholder value.

¶6. (C) With military activities subsiding, local newspapers have been increasingly filled this past week with articles about the economic cost of the war and its aftermath for Russia, citing especially the stock market losses and the downturn in business confidence. The Kremlin has seemed oblivious to these concerns, claiming that the economy is fundamentally strong and will quickly recover. Some local analysts agree, citing in particular Russia's status as the world's largest exporter of hydrocarbons. Chris Weafer of Uralsib noted in an August 27 e-mail to clients that Russia has \$1 billion in oil and gas revenue coming in each day and tensions with the West, including possible sanctions, will not affect this.

¶7. (C) However, other analysts are less sanguine. xxxxx told us that the decline in the stock market is "how the business community gets to vote about the government's economic policies." He said foreign

and Russian investors' bet on the Russian economy is on its "convergence" with Western economies. With that now in question, he and other analysts see the return of "high political risk" to the Russian economy and worry that it may be permanent. Although they don't see a 1998-style collapse

coming, they do see lower growth over time. In fact, most analysts have been systematically cutting their forecasts for 2008 growth over the past two weeks.

¶18. (C) The effect of the global credit crunch has been magnified by increased political risk in Russia, further raising the cost of capital. More expensive capital will cause Russian and foreign businesses here to delay or cancel expansion and improvement plans, lowering growth. The Russian economy is particularly vulnerable in this regard because it is heavily reliant on foreign capital for its long-term financing needs. Russian corporations reportedly have \$500 billion in increasingly expensive short-term foreign debt.

¶19. (C) According to xxxxx lower growth in turn ultimately puts at risk the grand bargain the GOR has made with the Russian people -) rising living standards in return for political quiescence. He believes, as do many of our other contacts, that a likely outcome is that the GOR will intervene and recapitalize Russian companies in place of the expensive foreign loans. Norilsk Nickel's Vladimir Potanin had a highly publicized meeting last week with Medvedev in which he reportedly asked for this. While xxxxx thought this might spark a market rally and ease the short-term costs to the Russian economy, he acknowledged that the long-term economic consequences would be negative.

Long Term Consequences

¶10. (C) A second myth about Russia's economy is that it has been moving beyond dependence on exports of natural resources and that its current prosperity is now driven by a self-perpetuating growth in consumer spending. In fact, the boom is threatening to go bust. Inflation has risen rapidly over the past year, exposing the underlying disconnect between supply and demand in the economy. Simply put, the energy bonanza has fueled sharply increased domestic demand and in the absence of an adequate supply response, prices have soared.

¶11. (C) The GOR explicitly acknowledged that economic growth was off kilter in the run-up to the presidential election in March. President Medvedev made a series of statements, the most famous his February "four I's" speech at the Krasnoyarsk Economic Forum, at which he called for fundamental reforms to the Russian economy, including: strengthening institutions, improving infrastructure, moving to a value added "innovation" economy, and improving the climate for investment. The net result, according to Medvedev and his inner circle, would be a more modern and more competitive economy.

¶12. (C) Medvedev's agenda appears to be one of the casualties of the war in Georgia. There was already entrenched opposition to the reforms within the ruling elite, and especially to Medvedev's emphasis on fighting official corruption and reducing state control. Much to the dismay of the majority of the business community, Medvedev's apparent loss of influence (reftel) would seem to put paid to the reforms, at least for the time being. It has also raised two very important questions: who is in charge of Russian economic policy and what are their objectives?

¶13. (C) The easy answers in the wake of the Georgian conflict would be Vladimir Putin and that his goal is maximizing the economic power of the state. However, it is more complicated than that. There are three primary economic tendencies or groups that are discernible within the Russian government elite. All of them enjoy some degree of support from the

"tandemocracy," and all of them have influence and shape policies.

¶14. (C) Two of these groups are generally characterized as economic "liberals" who favor market solutions: one group centered on Finance Minister Aleksey Kudrin and the other on President Medvedev in the person of his principal economic advisor, Arkadiy Dvorkovich. For Kudrin's group, which includes his Finance Ministry and the Central Bank, the watchword is stability. They favor more moderate growth and more gradual reforms. Dvorkovich's group, which includes the Presidential Administration and most of the Ministry of Economic Development, favors faster growth and faster reforms.

¶15. (C) These two groups probably agree on more issues than they disagree on, especially on the need for the modernization, integration and diversification of the economy encapsulated in Medvedev's reform agenda. However, a month ago it was their disagreements over inflation and taxes that were driving economic policy. Kudrin thought the economy was overheating and wanted to slow growth and rededicate the GOR to fiscal discipline. Dvorkovich argued for lower taxes to stimulate even faster growth which, when combined with structural reforms and infrastructure investments, would unleash the supply response he thought was needed to restore equilibrium to the economy.

¶16. (C) The result of the competition between these two groups seemed to be a healthy debate within the GOR that was likely to lead to a set of compromise economic policies that would have promoted Medvedev's reforms while emphasizing continued stability. xxxxx that the government's policies could be summed up as: legal reform, leading to reduced corruption, leading to increased economic freedom, leading to a surge in small and medium sized enterprises, leading to faster and better economic growth, the benefits of which would be more widely and evenly distributed.

¶17. (C) However, the third group within the governing elite that has a great deal of sway over economic policies -- the so-called "siloviki" -- has very different goals. They are not easily identifiable as a group and have no natural leader on a par with Kudrin, since their members are driven primarily by self-interest. They do, however, share two overarching characteristics: a preference for state control and a high tolerance for official corruption. They are often closely linked or overlap with another amorphous group, the "oligarchs," Russia's fabulously rich billionaires, most of whom made their money out of political connections, are loath to challenge the government in the wake of the Yukos affair, and an increasing percentage of whom, like Deputy Prime Minister Sechin or the head of state corporation Rostekhnologiya, Sergey Chemezov, have backgrounds in the security services.

¶18. (C) The siloviki are by all accounts the big winners out of recent events. There were reports that Medvedev was planning to move many of them aside in a fall government reshuffle. If such plans existed, they are now shelved. The siloviki are also the main opponents of modernization and integration, which would have limited their ability to extract rent from the economy. These individuals are now more likely to succeed in arguing for continuing state control, and therefore their control, over the commanding heights of the economy, especially the energy sector -- where the profits are high and the profit margins even higher.

¶19. (C) The Kremlin's consistent rejection of the economic consequences of its action, whether over the TNK-BP investor dispute, the Mechel incident, or the conflict with Georgia, has played into the siloviki's hands, reinforcing their authority and their ability to delay reforms. That said, the weakness of the siloviki's position, according to xxxxx and others, is that the long-term uncertainty about the GOR's commitment to market economics and international integration

) to playing by the rules at home and abroad) will inevitably reduce the economic resources at the government's disposal and that in turn will put their two principal objectives, personal enrichment and continued control of the country, in direct competition.

Comment

¶20. (C) There are two economic futures for Russia. The first is the one that Medvedev and the economic liberals have sketched out in the government's ambitious "2020" development plan. This future is that of an "innovation" economy that has diversified away from a reliance on commodity exports toward industries where Russia can add value. In this economic future, Russia's enormous revenues from oil and gas would have been used to transform and modernize the economy. 60 percent of Russians would be "middle class" providing a lasting force for political and economic stability. This future seemed poised to emerge as a central government priority just a few months ago; now it is clearly on a back burner.

¶21. (C) The darker future is one all too familiar to many countries that are blessed with natural resources and cursed with poor governance. It is a Russia still dependent on

volatile commodity exports, the surplus of which is easily captured by an entrenched and self-interested governing elite. It is a country of income extremes and unstable politics. And it is a country that, with its resources being rapidly depleted or with the world moving toward other energy sources, may have missed its chance at lasting prosperity.

¶22. (C) Both of these futures pose opportunities and threats for the U.S. A prosperous, more self-confident Russia is one that will require the intensive engagement and policy give-and-take that characterizes our relations with our European allies. It is less likely to be a Russia that threatens its neighbors and fears their stability and prosperity. A Russia still dependent on commodity exports will likely be intrinsically weaker and less influential globally, but lacking domestic accountability, it will pose more of threat to its neighbors and therefore to international order.

¶23. (C) Without doubt, the U.S. has a clear interest in the first future: for a more prosperous, better integrated, more stable Russia. With that in mind, we would argue that the U.S. needs to be careful that our efforts to demonstrate that Russia's actions vis-a-vis Georgia have real consequences do not play into the hands of the anti-reform circles who are promoting that other future.

¶24. (C) The Russians of course, especially the progressives around Medvedev, also face a difficult choice. Medvedev's recent public statements, especially the harsh rhetoric that Russia has nothing to fear from economic isolation, are contradicted by privately-expressed hopes that we not take steps to isolate them. They will ultimately have to decide when and how to confront their domestic opponents if they are to avoid this fate and if they are to resume their efforts to transform Russia's economy.
Beyrle